

## **APA Critical Assumptions**

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### **What is a Critical Assumption?**

- Rev. Proc. 96-53, § 5.07
- Objective Business and Economic Criteria
- Forms the Basis of a Proposed TPM
- Fact related to the Taxpayer, a Third party, an Industry, or Business and Economic Conditions
- Continued Existence of which is Material to the Proposed TPM

### **Examples**

- A particular mode of conducting business operations, i.e. manufacturing or distribution
- A particular corporate or business structure
- A range of expected business volume

### **Effects of Breaking a Critical Assumption**

- Failure to meet a critical assumption may render an APA inappropriate or unworkable
- Effect of failure to meet a critical assumption (Rev. Proc. 96-53, § 11.07) is that the APA be
  - Honored by both parties
  - Revised
  - Canceled.

### **Other Considerations**

- Bilateral cases - the foreign competent authority will be consulted, but in absence of agreement by the foreign competent authority the Service and the taxpayer can still reach an agreement.

### **Critical Assumption Notice**

- The taxpayer must notify the Service
- The Service itself may determine whether a critical assumption is met, perhaps using information gained on examination.

### **Uncontrollable Changes**

- A critical assumption may become unmet due to uncontrollable changes in economic circumstances
- a fundamental and dramatic change in the economic conditions of a particular industry.
- specify limits on how far actual sales may deviate from budgeted sales

## **Taxpayer's Actions**

- A critical assumption may become unmet due to a taxpayer's actions that are initiated for good faith business reasons
  - change in business strategy
  - mode of conducting operations
  - cessation or transfer of a business segment or entity covered by the APA

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## **Categories of Critical Assumptions (1991-1999)**

- ❑ *Operational*
- ❑ *Legal*
- ❑ *Tax*
- ❑ *Financial*
- ❑ *Accounting*
- ❑ *Economic*

### **- OPERATIONAL -**

## **Operational Critical Assumptions (1991- 1999)**

- Over 100 critical assumptions fell into the operational category

## **Costs or Expenses Assumptions**

- How the taxpayer defines, computes, allocates, and apportions costs and expenses
- Limits on the amount and manner by which expenses and costs can vary
- Example - U.S. subsidiary's deductions for restructuring fees shall not exceed a stated maximum dollar amount.

## **Sales Critical Assumptions**

- Limits on sales mixes, maximum sales amounts, projections of sales, and permissible sales trends and variations
- Example - Combined sales of covered products for each APA year must be within 20% of the previous year.

## **Other Operational Critical Assumptions**

- Operational critical assumptions involved variations in items other than sales or expenses
- How new or disposed of affiliates are treated
- Extent inventories can fluctuate
- Extent covered purchases can be imported finished products
- Example - The share of covered products that are imported finished goods can vary by X% from the historical baseline share percentage of imported finished goods

### **Change Critical Assumptions**

- State in a specific way that the following items remain substantially the same: customers, products, risks, functions, business methods, assets, pricing policies, absence of catastrophic events, business structure, presence and effect of a cost sharing agreement, functional currency, operating assets, presence or absence of intangible assets, intangible asset ownership, parties to the agreement, licensee agreements, specific personnel, location of specific personnel, presence or absence of commissions, and royalty amounts and percentages

### **Change Critical Assumptions - *Example***

- Example - The location of a particular key executive may not change

### **- LEGAL -**

### **Legal Critical Assumptions**

- Include nature and scope of competent authority agreements
- Example - That the competent authorities' mutual agreement, which is conditioned on the system profit remaining above a specified minimum level, will remain in effect (i.e., that such condition will continue to be satisfied).

### **Other Legal Critical Assumptions**

- Involve liquidations, dissolutions, customs law changes, major regulatory changes, new import or export barriers, and maintenance of a distributor agreement in a specific form.
- Example - Customs duties on imported covered products shall not vary beyond certain limits

### **Additional Legal Critical Assumptions**

- Involve which controlled entity has title to inventory and production equipment, or which controlled entity is required to maintain guarantees, warranties, or product liability
- Example - A parent corporation must maintain existing guarantees for all liabilities of its subsidiary, including its debt and product liability guarantees.

### **- TAX -**

### **Tax Critical Assumptions**

- Estimated tax liability
- Period of limitation on assessment
- Tax effect of specified expenses
- Sourcing of income
- Subpart F income
- Permanent establishment
- Foreign tax credit limitation
- Increasing coverage to other controlled foreign corporations

### **Other Tax Critical Assumptions**

- Ability to change a specified tax election
- Ability to file for a refund
- Condition of subsequently entering into a closing agreement for rollback years.

### **Tax Critical Assumptions**

- Example - That the period of limitation on assessments shall be kept open for all APA years until such period expires for the last APA year under U.S. tax law
- Note - It probably would have been better not to have a critical assumption for this, but instead to state that the taxpayer had an obligation to keep the statute of limitations open

### **- FINANCIAL -**

### **Financial Critical Assumptions**

- Limitations on system loss
- Intangible profit projections
- Buy-in payments
- Lack of currency risk
- Valid business reason for debt.

### **Other Financial Critical Assumptions**

- Also included in this category are a number of requirements for maintaining various financial ratios such as profit splits, Berry ratios, operating profit margins, and gross profit margins, within prescribed ranges or within limits.

### **Financial Critical Assumptions - Example**

- Example - TPM may not yield a gross margin outside A% to B% for a controlled subsidiary, nor may the combined operating margins be outside C% to D% for the parent and the subsidiary, unless due to valid business reasons or attributable to economic conditions beyond the parent's control.

### **- ACCOUNTING -**

### **Accounting Critical Assumptions**

- Use of generally accepted accounting principles
- Favorable certified opinions
- Mark to market accounting
- Consistency of accounting computations for all related parties
- Methods of accounting for foreign currency gains and losses
- Unchanged methods for both financial and tax accounting

### **Accounting Critical Assumptions - Example**

- Example - Manufacturing costs must be computed in the same manner by U.S. and foreign members of an affiliated group
- Note - These type of critical assumption probably often could have been expressed instead as an obligation of the taxpayer

### **- ECONOMIC -**

### **Economic Critical Assumptions**

- Interest rates and changes in interest rates
- No significant changes in market conditions, technology, product liability, product design, process design, and market share.

### **Economic Critical Assumptions - Example**

- Example - There shall not be an unexpected economic development that materially affects a company's market share or market price of a covered product.

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### **Guidelines for Critical Assumption Use**

- ❑ *Make critical assumptions extreme outer limits*
- ❑ *Try to use TPM provisions rather than critical assumptions*
- ❑ *Do not confuse critical assumptions with the scope of the APA*
- ❑ *Do not confuse critical assumptions with obligations of the taxpayer*

### **Make Critical Assumptions Extreme Outer Limits**

- If they are unmet, things have changed so much that cancellation would be appropriate
- Also, taxpayers will be less able to manipulate a failure of the assumption
- With this approach critical assumptions will not fail so much
- It is a shame to conclude an APA after much effort, only to be back at the negotiating table after a critical assumption fails

### **Use TPM Provisions Rather than Critical Assumptions - I**

- Example - Instead of having a critical assumption that sales not fluctuate too much from budgeted amounts, it might be possible instead to provide that such fluctuations will cause certain adjustments to the range.

### **Use TPM Provisions Rather than Critical Assumptions -II**

- Example - An APA uses a CPM with a gross margin PLI for a U.S. distributor. The Service is worried that the distributor will make excessive advertising expenditures without reimbursement from the parent, with the effect of building up the parent's marketing intangibles. Critical Assumption against excessive advertising payments.

### **Use TPM Provisions Rather than Critical Assumptions -III**

- Example Solution - Instead of having a critical assumption that advertising expenses must be within a certain level, one could specify that for purposes of computing the distributor's gross profit level during the APA years, advertising expenses above a certain amount will be subtracted from sales

### **Do Not Confuse Critical Assumptions with the Scope of the APA**

- Example –An APA may specify that new product types will not be covered. This provision should be part of the definition of covered transactions; the APA should not include a critical assumption that new products not be introduced

### **Do Not Confuse Critical Assumptions with Obligations of the Taxpayer**

- Example - An APA may require a taxpayer to record certain information in a regularly compiled database. This requirement could be put in an additional paragraph in the text of the APA, with language clearly stating that taxpayer was committing to this obligation as an express term of the APA. If the taxpayer does not do so, the taxpayer has violated the terms and conditions of the APA, which gives the Service the option to either enforce or cancel/revoke the APA. This obligation of the taxpayer is not a critical assumption and should not be so labeled

### **Conclusion of Critical Assumptions**

- Always ask the question – “Is the issue addressed a critical assumption, or is it more appropriately a required term of the APA?”